

## Internal Revenue Service

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Re:

### LEGEND:

Trustor	=
Spouse	=
Child A	=
Grandchild A	=
Child B	=
Grandchild B-1	=
Grandchild B-2	=
Grandchild B-3	=
Trust	=
Marital Trust	=
Family Trust	=
Child B Trust	=
Grandchild A Trust	=
Grandchild B-1 Trust	=
Grandchild B-2 Trust	=
Grandchild B-3 Trust	=
Liquid Assets	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=
State	=

State Court =

State Statute 1 =

State Statute 2 =

State Statute 3 =

Cite 1 =

Cite 2 =

Cite 3 =

Cite 4 =

Cite 5 =

Cite 6 =

Cite 7 =

Cite 8 =

Cite 9 =

Dear

This responds to your representative's letter dated July 28, 2011, requesting rulings on the gift and generation-skipping transfer tax consequences of a judicial construction of a trust.

The facts submitted and the representations made are as follows: On Date 1, Trustor executed a revocable trust (Trust) that became irrevocable at her death. Under Article III and Article V(c) and (d) of Trust, at Trustor's death, a fractional amount of Trust property is to be held in trust (Marital Trust) for the lifetime benefit of Spouse. Article V(c) and (d) provide Spouse may exercise a testamentary general power to appoint the Marital Trust property. If Spouse fails to exercise the power, the Marital Trust property remaining at his death is to pass to the trust described below (Family Trust).

Article V(d)(2) provides that the remaining Trust property is to be distributed to the Family Trust created under Article VI. Under Article VI(a), the Family Trust property is to be divided into six separate trusts of equal value for each child and grandchild of Trustor, set forth as Child A, Child A's child (Grandchild A), Child B, and Child B's three children (Grandchild B-1, Grandchild B-2, and Grandchild B-3). Child A predeceased Trustor.

Under Article VI(d), the income of each separate trust for each child and

grandchild of Trustor is to be distributed to the beneficiary annually or more frequently if in the trustee's judgment it is convenient and appropriate to do so. The corpus of the separate trust may be invaded, in the trustee's discretion, to assist the beneficiary in emergencies arising out of or connected with illness, accident, inflation or other similar events over which the beneficiary has no control.

Article VI: Distribution at a beneficiary's death

Child B Trust. Under Article VI(b)(ii), on Child B's death, her trust estate is to be distributed equally among the *then existing trusts* created under and pursuant to Article VI(a), but if there is none, the Child B Trust estate is to be distributed to Spouse's heirs as determined by State law then in force. (Emphasis added).

Grandchild Trusts. Under Article VI(b)(iii), on the death of any one of Trustor's grandchildren, that deceased grandchild's trust is to be administered as follows. If the deceased grandchild leaves descendants, the trust income is to be distributed equally among them until the youngest descendant attains age 21, whereupon the trust estate is to be distributed to the then beneficiaries and their respective children, if any, under the principle of representation. If the deceased grandchild leaves no surviving descendants, then the trustee is to distribute the trust estate to the other *then existing trusts* set up and created under and pursuant to Article VI. (Emphasis added).

Trustor died on Date 2, a date prior to September 25, 1985, survived by Spouse, Child B, Grandchild A, Grandchild B-1, Grandchild B-2, and Grandchild B-3. Marital Trust was created for Spouse. The remaining Trust property was divided equally among five separate trusts, i.e., Child B Trust for Child B, Grandchild A Trust for Grandchild A, Grandchild B-1 Trust for Grandchild B-1, Grandchild B-2 Trust for Grandchild B-2, and Grandchild B-3 Trust for Grandchild B-3.

Spouse died on Date 3, a date prior to September 25, 1985, without exercising his general power of appointment. The Marital Trust property was divided equally among the five separate trusts, i.e., Child B Trust, Grandchild A Trust, Grandchild B-1 Trust, Grandchild B-2 Trust and Grandchild B-3 Trust. Grandchild A and Grandchild B-1 are the trustees. Trust and the separate trusts are governed by State law.

Grandchild B-1 and Grandchild B-3 are beneficiaries of his respective grandchild's trust. Each of them has descendants. Grandchild A is the beneficiary of his respective trust. However, Grandchild A has no descendants.

Child B was the beneficiary of her trust until she died on Date 5. The Child B Trust assets are now distributable to the then existing trusts. Grandchild B-2 was the beneficiary of her trust until she died on Date 4. Under Article VI(b)(iii), the trustees distributed the Liquid Assets of Grandchild B-2 Trust to her children.

On Date 6, the trustees filed a petition in State Court requesting construction of the “then existing trusts” language of Article VI(b)(ii) and (iii). The trustees asked the court to consider that: (i) Trustor (and Spouse) intended an equal division of the Trust property among their four grandchildren, whose descendants would receive a respective grandchild’s share; (ii) Grandchild B-2 Trust existed at Child B’s death because, after the trustees distributed the Liquid Assets, Grandchild B-2 Trust continued to hold interests (consisting of a vested interest in Child B Trust and a defeasible interest in the other grandchildren’s trusts); and (iii) because each grandchild’s trust exists so long as it holds a defeasible interest in the other grandchildren’s trusts, a trust for a grandchild leaving no issue is divisible in equal shares among the three other grandchildren’s trusts.

State Court concluded that Trustor (and Spouse) intended for the Child B Trust assets to be shared by all four grandchildren’s trusts and, if a grandchild were to die with no descendants, his or her trust was to be divided equally among the three remaining grandchildren’s trusts. The court’s order is effective upon the trustees’ receipt of a favorable private letter ruling.

We have been asked to rule that:

- (1) The court’s construction will not cause the Trust and the five separate trusts to lose the exemption from the generation-skipping transfer tax, and
- (2) The court’s construction will not cause any beneficiary of a separate trust to be deemed to make a gift for federal gift tax purposes.

### Law

In Commissioner v. Estate of Bosch, 387 U.S. 456 (1967), the Court considered whether a state trial court’s characterization of property rights conclusively binds a federal court or agency in a federal estate tax controversy. The Court concluded that the decision of a state trial court as to an underlying issue of state law should not be controlling when applied to a federal statute. Rather, the highest court of the state is the best authority on the underlying substantive rule of state law to be applied in the federal matter. If there is no decision by that court, then the federal authority must apply what it finds to be state law after giving “proper regard” to the state trial court’s determination and to relevant rulings of other courts of the state. In this respect, the federal agency may be said, in effect, to be sitting as a state court.

### State law

State Statute 1 provides, in part, that a trust terminates to the extent it expires pursuant to its terms, no purpose of the trust remains to be achieved, or the purposes of the trust have become unlawful, contrary to public policy, or impossible to achieve.

Under State law, a court may reform the terms of a trust to conform to the settlor's intentions. State Statute 2. The question of whether there is a scrivener's error or ambiguity is a question of law. Cite 1; Cite 2; Cite 3; Cite 8. In construing a trust, the court looks to the four corners of the instrument to determine the settlor's intentions, which are controlling. The court construes the trust in the light of its language and particular facts. Cite 9.

The courts of State construe the term "trust property" expansively to include contingent interests and interests subject to divestiture. A valid trust may exist even though its sole asset is a remainder interest subject to divestiture. See State Statute 3; Cite 4; Cite 5; Cite 6; Cite 7.

### Issue 1:

Section 2601 of the Internal Revenue Code imposes a tax on every generation-skipping transfer (GST), which is defined under § 2611 as a taxable distribution, a taxable termination, and a direct skip.

Under § 1433 of the Tax Reform Act of 1986 (Act), the GST tax is generally applicable to generation-skipping transfers made after October 22, 1986. However, under § 1433(b)(2)(A) of the Act and § 26.2601-1(b)(1)(i) of the Generation-Skipping Transfer Tax Regulations, the tax does not apply to a transfer under a trust that was irrevocable on September 25, 1985, provided no additions (actual or constructive) were made to the trust after that date.

Section 26.2601-1(b)(2) provides that the GST tax does not apply to any generation-skipping transfer under a will or other revocable trust executed before October 22, 1986, provided that the document in existence on October 21, 1986, is not amended at any time after October 21, 1986, in any respect which results in the creation of, or an increase in the amount of, a generation-skipping transfer, and the decedent dies before January 1, 1987.

Section 26.2601-1(b)(4)(i) provides rules for determining when a modification, judicial construction, settlement agreement, or trustee action with respect to a trust that is exempt from the GST tax under § 26.2601-1(b) will not cause the trust to lose its exempt status. The regulation provides that the rules contained in the paragraph are

applicable only for purposes of determining whether an exempt trust retains its exempt status for GST tax purposes. The rules do not apply in determining, for example, whether the transaction results in a gift subject to gift tax, or may cause the trust to be included in the gross estate of a beneficiary, or may result in the realization of capital gain for purposes of § 1001.

Section 26.2601-1(b)(4)(i)(C) provides that a judicial construction of a governing instrument to resolve an ambiguity in the terms of the instrument or to correct a scrivener's error will not cause an exempt trust to be subject to the GST provisions if: (1) the judicial action involves a bona fide issue; and (2) the construction is consistent with applicable state law that would be applied by the highest court of the state.

Section 26.2601-1(b)(4)(i)(E), Example 3, considers a situation where, in 1980, Grantor established an irrevocable trust for the benefit of Grantor's children, A and B, and their issue. The trust is to terminate on the death of the last to die of A and B, at which time the principal is to be distributed to their issue. However, the provision governing the termination of the trust is ambiguous regarding whether the trust principal is to be distributed per stirpes, only to the children of A and B, or per capita among the children, grandchildren, and more remote issue of A and B. In 2002, the trustee files a construction suit with the appropriate local court to resolve the ambiguity. The court issues an order construing the instrument to provide for per capita distributions to the children, grandchildren, and more remote issue of A and B living at the time the trust terminates. The court's construction resolves a bona fide issue regarding the proper interpretation of the instrument and is consistent with applicable state law as it would be interpreted by the highest court of the state. Therefore, the trust will not be subject to the GST tax.

Trust was irrevocable on September 25, 1985, and the trustees represent that there have been no additions to Trust or any of the separate trusts after September 25, 1985.

In this case, an examination of the documents and State law confirms that Trustor and Spouse intended each grandchild's separate trust to continue in existence for purposes of acquiring the Child B Trust assets and the trust assets of a grandchild dying without descendants. Accordingly, we conclude that State Court's construction of the "then existing trust" language of Article VI(b)(ii) and (iii) resolves a bona fide issue and is consistent with applicable State law that would be applied by the highest court of State.

Accordingly, based on the facts presented and the representations made, the construction of the phrase "then existing trusts" in Article VI(b)(ii) and (iii) of Trust will not cause Trust or a separate trust to lose its exempt status for purposes of the GST tax under § 2601.

Issue 2:

Section 2501(a) imposes a gift tax for each calendar year on the transfer of property by gift during the year by an individual.

Section 2511 provides that the gift tax shall apply whether the transfer is in trust or otherwise, whether the gift is direct or indirect, and whether the property is real or personal, tangible or intangible.

Section 2512(a) provides that if the gift is made in property, the value thereof at the date of the gift is considered the amount of the gift.

Section 2512(b) provides that where property is transferred for less than an adequate consideration in money or money's worth, then the amount by which the value of the property exceeded the value of the consideration is deemed a gift.

In this case, an examination of the relevant documents indicates an ambiguity that is contrary to the intent of Trustor and Spouse. Further, State Court's construction is consistent with applicable State law that would be applied in the highest court of State. Accordingly, based on the facts presented and the representations made, we conclude that State Court's construction of Article VI(b)(ii) and (iii) will not cause a beneficiary of Trust or the separate trusts to be deemed to have made a gift for gift tax purposes.

In accordance with the Power of Attorney on file with this office, a copy of this letter is being sent to your authorized representative.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

This ruling is directed only to the taxpayer requesting it. Section 6110(k)(3) provides that it may not be used or cited as precedent.

Sincerely,

Leslie H. Finlow  
Senior Technician Reviewer, Branch 4  
Office of the Associate Chief Counsel  
(Passthroughs & Special Industries)

Enclosure  
Copy for § 6110 purposes